.01 Added by P L. 103-66.

Committee Reports on P.L. 103-66 (Omnibus Budget Reconciliation Act of 1993)

.70 Amortization of goodwill.—The bill allows an amortization deduction with respect to the capitalized costs of certain intangible property (defined as a "section 197 intangible") that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over a 14-year period that begins with the month that the intangible is acquired.[126] No other depreciation or amortization deduction is allowed with respect to a section 197 intangible that is acquired by a taxpayer.

In general, the bill applies to a section 197 intangible acquired by a taxpayer regardless of whether it is acquired as part of a trade or business. In addition, the bill generally applies to a section 197 intangible that is treated as acquired under section 338 of the Code. The bill generally does not apply to a section 197 intangible that is created by the taxpayer if the intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof.

Except in the case of amounts paid or incurred under certain covenants not to compete (or under certain other arrangements that have substantially the same effect as covenants not to compete) and certain amounts paid or incurred on account of the transfer of a franchise, trademark, or trade name, the bill generally does not apply to any amount that is otherwise currently deductible (i.e., not capitalized) under present law.

No inference is intended as to whether a depreciation or amortization deduction is allowed under present law with respect to any intangible property that is either included in, or excluded from, the definition of a section 197 intangible. In addition, no inference is intended as to whether an asset is to be considered tangible or intangible property for any other purpose of the Internal Revenue Code.

Definition of section 197 intangible.—

In general.—The term "section 197 intangible" is defined as any property that is included in any one or more of the following categories: (1) goodwill and going concern value; (2) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (3) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (4) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (5) any franchise, trademark, or trade name.

Certain types of property, however, are specifically excluded from the definition of the term "section 197 intangible." The term "section 197 intangible" does not include: (1) any interest in a corporation, partnership, trust, or estate; (2) any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract; (3) any interest in land; (4) certain computer software; (5) certain interests in films, sound recordings, video tapes, books, or other similar property; (6) certain rights to receive tangible property or services; (7) certain interests in patents or copyrights; (8) any interest under an existing lease of tangible property; (9) any interest under an existing indebtedness (except for the deposit base and similar items of a financial institution); (10) a franchise to engage in any professional sport, and any item acquired in connection with such a franchise; and (11) certain transaction costs.

In addition, the Treasury Department is authorized to issue regulations that exclude certain rights of fixed duration or amount from the definition of a section 197 intangible.

Goodwill and going concern value.—For purposes of the bill, goodwill is the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value is the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value includes the value that is attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership. Going concern value also includes the value that is attributable to the use or availability of an acquired trade or business (for example, the net earnings that otherwise would not be received during any period were the acquired trade or business not available or operational).

Workforce, information base, know-how, customer-based intangibles, supplier-based intangibles and other similar items.—

Workforce.—The term "section 197 intangible" includes workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce is to be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring an existing employment contract (or contracts) or a relationship with employees or consultants (including but not limited to any "key employee" contract or relationship) as part of the acquisition of a trade or business is to be amortized over the 14-year period specified in the bill.

Information base.—The term "section 197 intangible" includes business books and records, operating systems, and any other information base including lists or other information with respect to current or prospective customers (regardless of the method of recording such information). Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems is to be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring customer lists, subscription lists, insurance expirations,[127] patient or client files, or lists of newspaper, magazine, radio or television ad-

[126] In the case of a short taxable year, the amortization deduction is to be based on the number of months in such taxable year.

[127] Insurance expirations are records that are maintained by insurance agents with respect to insurance customers. These records generally include information

vertisers is to be amortized over the 14-year period specified in the bill.

Know-how.—The term "section 197 intangible" includes any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term "section 197 intangible" is to include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.[128]

Customer-based intangibles.—The term "section 197 intangible" includes any customer-based intangible, which is defined as the composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services, is to be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for those goods or services that have been provided to customers prior to the acquisition of a trade or business is not to be taken into account under the bill.[129]

In addition, the bill specifically provides that the term "customer-based intangible" includes the deposit base and any similar asset of a financial institution. Thus, for example, the portion (if any) of the purchase price of an acquired financial institution that is attributable to the checking accounts, savings accounts, escrow accounts and other similar items of the financial institution is to be amortized over the 14-year period specified in the bill.

Supplier-based intangibles.—The term "section 197 intangible" includes any supplier-based intangible, which is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, is to be amortized over the 14-year period specified in the bill.[130]

Other similar items.—The term "section 197 intangible" also includes any other intangible property that is similar to workforce, information base, know-how, customer-based intangibles, or supplier-based intangibles.

Licenses, permits, and other rights granted by governmental units.—The term "section 197 intangible" also includes any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof (even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period).[131] Thus, for example, the capitalized cost of acquiring from any person a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (which is sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license is to be amortized over the 14-year period specified in the bill. For purposes of the bill, the issuance or renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof is to be considered an acquisition of such license, permit, or other right.

Covenants not to compete and other similar arrangements.—The term "section 197 intangible" also includes any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete; hereafter "other similar arrangement") entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) is chargeable to capital account and is to be amortized ratably over the 14-year period specified in the bill. In addition, any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) after the taxable year in which the covenant (or other similar arrangement) was entered into is to be amortized ratably over the remaining months in the 14-year amortization period that applies to the covenant (or other similar arrangement) as of the beginning of the month that the amount is paid or incurred.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefit the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete (or other similar arrangement) represents additional consideration for the acquisition of stock in a corporation, such amount is not to be taken into account

(Footnote Continued)

relating to the type of insurance, the amount of insurance, and the expiration date of the insurance.

[128] See below for a description of the exceptions for certain patents, certain computer software, and certain interests in films, sound recordings, video tapes, books, or other similar property.

[129] As under present law, the portion of the purchase price of an acquired trade or business that is attributable to accounts receivable is to be allocated among such receivables and is to be taken into account as payment is received under each receivable or at the time that a receivable becomes worthless.

[130] See below, however, for a description of the exception for certain rights to receive tangible property or services from another person.

[131] A right granted by a governmental unit or an agency or instrumentality thereof that constitutes an interest in land or an interest under a lease of tangible property is excluded from the definition of a section 197 intangible. See below for a description of the exceptions for interests in land and for interests under leases of tangible property.

under this provision but, instead, is to be included as part of the acquirer's basis in the stock.

Franchises, trademarks, and trade names.—The term "section 197 intangible" also includes any franchise, trademark, or trade name. For this purpose, the term "franchise" is defined, as under present law, to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.[132] In addition, as provided under present law, the renewal of a franchise, trademark, or trade name is to be treated as an acquisition of such franchise, trademark, or trade name.[133]

The bill continues the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction is allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula.[134] Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name is chargeable to capital account and is to be amortized ratably over the 14-year period specified in the bill.

Exceptions to the definition of a section 197 intangible.—

In general.—The bill contains several exceptions to the definition of the term "section 197 intangible." Several of the exceptions contained in the bill apply only if the intangible property is not acquired in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business. It is anticipated that the Treasury Department will exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term "section 197 intangible" to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the acquisition of an asset which constitutes a trade or business or a substantial portion of a trade or business.

The determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. It is not intended, however, that the value of the assets acquired relative to the value of the assets retained by the transferor is determinative of whether the acquired assets constitute a substantial portion of a trade or business.

For purposes of the bill, a group of assets is to constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (i.e., if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, the acquisition of a franchise, trademark or trade name is to constitute the acquisition of a trade or business or a substantial portion of a trade or business.

In determining whether a taxpayer has acquired an intangible asset in a transaction (or series of related transactions) that involves the acquisition of assets that constitute a trade or business or a substantial portion of a trade or business, only those assets acquired in a transaction (or a series of related transactions) by a taxpayer (and persons related to the taxpayer) from the same person (and any related person) are to be taken into account. In addition, any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of assets are to be taken into account in determining whether the transferred assets constitute a trade or business or a substantial portion of a trade or business.

Interests in a corporation, partnership, trust, or estate.—The term "section 197 intangible" does not include any interest in a corporation, partnership, trust, or estate. Thus, for example, the bill does not apply to the cost of acquiring stock, partnership interests, or interests in a trust or estate, whether or not such interests are regularly traded on an established market.[135]

Interests under certain financial contracts.—The term "section 197 intangible" does not include any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not such interest is regularly traded on an established market. Any interest under a mortgage servicing contract, credit card servicing contract or other contract to service indebtedness issued by another person, and any interest under an assumption reinsurance contract[136] is not excluded from the definition of the term "section 197 intangible" by reason of the exception for interests under certain financial contracts.

Interests in land.—The term "section 197 intangible" does not include any interest in land. Thus, the cost of acquiring an interest in land is to be taken into account under present law rather than under the bill. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights with respect to land. An interest in land is not to include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television services.

The costs of acquiring licenses, permits, and other rights relating to improvements to land, such as building construction or use permits, are to be taken into account in the same manner as the underlying improvement in accordance with present law.

Certain computer software.—The term "section 197 intangible" does not include computer software (whether acquired as part of a trade or business or otherwise) that (1) is readily available for purchase by the general public; (2) is subject to a nonexclusive license; and (3) has not been substantially modified. In addition, the term "section 197 intangible" does not include computer software which is not acquired in a transaction (or a

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[132] Section 1253(b)(1) of the Code.

[133] Only the costs incurred in connection with the renewal, however, are to be amortized over the 14-year period that begins with the month that the franchise, trademark, or trade name is renewed. Any costs incurred in connection with the issuance (or an earlier renewal) of a franchise, trademark, or trade name are to continue to be taken into account over the remaining portion of the amortization period that began at the time of such issuance (or earlier renewal).

[134] Section 1253(d)(1) of the Code.

[135] A temporal interest in property, outright or in trust, may not be used to convert a section 197 intangible into property that is amortizable more rapidly than ratably over the 14-year period specified in the bill.

[136] See below for a description of the treatment of assumption reinsurance contracts.

series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

For purposes of the bill, the term "computer software" is defined as any program (i.e., any sequence of machine-readable code) that is designed to cause a computer to perform a desired function. The term "computer software" includes any incidental and ancillary rights with respect to computer software that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software. The term "computer software" does not include any data base or similar item (other than a data base or item that is in the public domain and that is incidental to the software)[137] regardless of the form in which it is maintained or stored.

If a depreciation deduction is allowed with respect to any computer software that is not a section 197 intangible, the amount of the deduction is to be determined by amortizing the adjusted basis of the computer software ratably over a 36-month period that begins with the month that the computer software is placed in service. For this purpose, the cost of any computer software that is taken into account as part of the cost of computer hardware or other tangible property under present law is to continue to be taken into account in such manner under the bill. In addition, the cost of any computer software that is currently deductible (*i.e.*, not capitalized) under present law is to continue to be taken into account in such manner under the bill.

Certain interests in films, sound recordings, video tapes, books, or other similar property.—The term "section 197 intangible" does not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property (including the right to broadcast or transmit a live event) if the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

Certain rights to receive tangible property or services.—The term "section 197 intangible" does not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to a right to receive tangible property or services that is not a section 197 intangible, the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that in the case of an amortizable right to receive tangible property or services in substantially equal amounts over a fixed period that is not renewable, the cost of acquiring the right will be taken into account ratably over such fixed period. It is also anticipated that the regulations may provide that in the case of a right to receive a fixed amount of tangible property or services over an unspecified period, the cost of acquiring such right will be taken into account under a method that allows a deduction based on the amount of tangible property or services received during a taxable year compared to the total amount of tangible property or services to be received.

For example, assume that a taxpayer acquires from another person a favorable contract right of such person to receive a specified amount of raw materials each month for the next three years (which is the remaining life of the contract) and that the right to receive such raw materials is not acquired as part of the acquisition of assets that constitute a trade or business or a substantial portion thereof (*i.e.*, such contract right is not a section 197 intangible). It is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right ratably over the three-year remaining life of the contract. Alternatively, if the favorable contract right is to receive a specified amount of raw materials during an unspecified period, it is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which is the amount of raw materials received under the contract during any taxable year and the denominator of which is the total amount of raw materials to be received under the contract.

It is also anticipated that the regulations may require a taxpayer under appropriate circumstances to amortize the cost of acquiring a renewable right to receive tangible property or services over a period that includes all renewal options exercisable by the taxpayer at less than fair market value.

Certain interests in patents or copyrights.—The term "section 197 intangible" does not include any interest in a patent or copyright which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to an interest in a patent or copyright and the interest is not a section 197 intangible, then the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is expected that the regulations may provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent equals the amount of the royalty paid or incurred during such year.[138]

Interests under leases of tangible property.—The term "section 197 intangible" does not include any interest as a lessor or lessee under an existing lease of tangible property (whether real or personal).[139] The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property is to be taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases is to be taken into account as a part of the basis of the shopping center and is to be taken into account in determining the depreciation deduction allowed with respect to the shopping center.

The cost of acquiring an interest as a lessee under an existing lease of tangible property is to be taken into account under present law (see section 178 of the Code

[137] For example, a data base would not include a dictionary feature used to spell-check a word processing program.

[138] See *Associated Patentees, Inc.*, 4 T.C. 979 (1945), and Rev. Rul. 67-136, 1967-1 C.B. 58.

[139] The bill provides that a sublease is to be treated in the same manner as a lease of the underlying property. Thus, the term "section 197 intangible" does not include any interest as a sublessor or sublessee of tangible property.

and Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill.[140] In the case of any interest as a lessee under a lease of tangible property that is acquired with any other intangible property (either in the same transaction or series of related transactions), however, the portion of the total purchase price that is allocable to the interest as a lessee is not to exceed the excess of (1) the present value of the fair market value rent for the use of the tangible property for the term of the lease,[141] over (2) the present value of the rent reasonably expected to be paid for the use of the tangible property for the term of the lease.

Interests under indebtedness.—The term "section 197 intangible" does not include any interest (whether as a creditor or debtor) under any indebtedness that was in existence on the date that the interest was acquired.[142] Thus, for example, the value of assuming an existing indebtedness with a below-market interest rate is to be taken into account under present law rather than under the bill. In addition, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument. This exception for interests under existing indebtedness does not apply to the deposit base and other similar items of a financial institution.

Professional sports franchises.—The term "section 197 intangible" does not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other section 197 intangibles) is to be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and is to be taken into account under the provisions of present law.

Certain transaction costs.—The term "section 197 intangible" does not include the amount of any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C. This provision addresses a concern that some taxpayers might attempt to contend that the 14-year amortization provided by the provision applies to any such amounts that may be required to be capitalized under present law but that do not relate to any asset with a readily identifiable useful life.[143] The exception is provided solely to clarify that section 197 is not to be construed to provide 14-year amortization for any such amounts. No inference is intended that such amounts would (but for this provision) be properly characterized as amounts eligible for such 14-year amortization, nor is any inference intended that any amounts not specified in this provision should be so characterized. In addition, no inference is intended regarding the proper treatment of professional fees or transaction costs in other circumstances under present law.

Regulatory authority regarding rights of fixed term or duration.—The bill authorizes the Treasury Department to issue regulations that exclude a right received under a contract, or granted by a governmental unit or an agency or instrumentality thereof, from the definition of a section 197 intangible if (1) the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business (or a substantial portion thereof) and (2) the right either (A) has a fixed duration of less than 14 years or (B) is fixed as to amount [144] and the cost is properly recoverable (without regard to this provision) under a method similar to the unit of production method.

Generally, it is anticipated that the mere fact that a taxpayer will have the opportunity to renew a contract or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will not be taken into account in determining the duration of such right or whether it is for a fixed amount. However, the fact that competitive bidding occurs at the time of renewal and that there are or may be modifications in price (or in terms or requirements relating to the right that increase the cost to the bidder) shall not be within the scope of the preceding sentence unless the bidding also actually produces a fair market value price comparable to the price that would obtain if the rights were purchased immediately after renewal from a person (other than the person granting the renewal) in an arm's length transaction. Furthermore, it is expected that, as under present law, the Treasury Department will take into account all the facts and circumstances, including any facts indicating an actual practice of renewals or expectancy of renewals.

For example, assume Company A enters into a license with Company B to use certain know-how developed by B. In addition, assume that the license is for five years, that the license cannot be renewed by A except on terms that are fully available to A's competitors and that the price paid by A will reflect the arm's length price that a third party would pay A for the license immediately after renewal. Finally, assume that the license does not constitute a substantial portion of a trade or business and is not entered into as part of a transaction (or series of related transactions) that constitute the acquisition of a trade or business or substantial portion thereof. It is anticipated that in these circumstances the regulations will provide that the license is not a section 197 intangible because it is of fixed duration.

The regulations may also prescribe rules governing the extent to which renewal options and similar items will be taken into account for the purpose of determining

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[140] The lease of a gate at an airport for the purpose of loading and unloading passengers and cargo is a lease of tangible property for this purpose. It is anticipated that such treatment will serve as guidance to the Internal Revenue Service and taxpayers in resolving existing disputes.

[141] In no event is the present value of the fair market value rent for the use of the tangible property for the term of the lease to exceed the fair market value of the tangible property as of the date of acquisition. The present value of such rent is presumed to be less than the value of the tangible property if the duration of the lease is less than the economic useful life of the property.

[142] For purposes of this exception, the term "interest under any existing indebtedness" is to include mortgage servicing rights to the extent that the rights are stripped coupons under section 1286 of the Code. See Rev. Rul. 91-46, 1991-34 I.R.B. 5 (August 26, 1991).

[143] See, e.g. *INDOPCO, Inc. v. Commissioner*, 112 S.Ct. 1039 (1992).

[144] For example, an emission allowance granted a public utility under Title IV of the Clean Air Act Amendments of 1990 is a right that is limited in amount within the meaning of this provision, because each allowance grants a right to a fixed amount of emissions. It is expected that the Treasury Department will provide guidance regarding the interaction of section 461 with these provisions. No inference is intended that would require the Treasury Department to disturb the result in Rev. Proc. 92-91, 1992-46 I.R.B. 32.

whether rights are fixed in duration or amount. It is also anticipated that such regulations may prescribe the appropriate method of amortizing the capitalized costs of rights which are excluded by such regulations from the definition of a section 197 intangible.

Exception for certain self-created intangibles.—The bill generally does not apply to any section 197 intangible that is created by the taxpayer if the section 197 intangible is not created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof.

For purposes of this exception, a section 197 intangible that is owned by a taxpayer is to be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. For example, a technological process or other know-how that is developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process or know-how is to be considered created by the taxpayer.

The exception for "self-created" intangibles does not apply to the entering into (or renewal of) a contract for the use of a section 197 intangible. Thus, for example, the exception does not apply to the capitalized costs incurred by a licensee in connection with the entering into (or renewal of) a contract for the use of know-how or other section 197 intangible. These capitalized costs are to be amortized over the 14-year period specified in the bill.

In addition, the exception for "self-created" intangibles does not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, the capitalized costs incurred in connection with the development or registration of a trademark or trade name are to be amortized over the 14-year period specified in the bill.

Special rules.—

Determination of adjusted basis.—The adjusted basis of a section 197 intangible that is acquired from another person generally is to be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is to be amortized ratably over the remaining months in the 14-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

Treatment of certain dispositions of amortizable section 197 intangibles.—Special rules apply if a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions and, after the disposition,[145] the taxpayer retains other section 197 intangibles that were acquired in such transaction or series of related transactions.[146] First, no loss is to be recognized by reason of such a disposition. Second, the adjusted bases of the retained section 197 intangibles that were acquired in connection with such transaction or series of related transactions are to be increased by the amount of any loss that is not recognized. The adjusted basis of any such retained section 197 intangible is increased by the product of (1) the amount of the loss that is not recognized solely by reason of this provision and (2) a fraction, the numerator of which is the adjusted basis of the intangible as of the date of the disposition and the denominator of which is the total adjusted bases of all such retained section 197 intangibles as of the date of the disposition.

For purposes of these rules, all persons treated as a single taxpayer under section 41(f)(1) of the Code are treated as a single taxpayer. Thus, for example, a loss is not to be recognized by a corporation upon the disposition of a section 197 intangible if after the disposition a member of the same controlled group as the corporation retains other section 197 intangibles that were acquired in the same transaction (or a series of related transactions) as the section 197 intangible that was disposed of. It is anticipated that the Treasury Department will provide rules for taking into account the amount of any loss that is not recognized due to this rule (for example, by allowing the corporation that disposed of the section 197 intangible to amortize the loss over the remaining portion of the 14-year amortization period).

Treatment of certain nonrecognition transactions.—If any section 197 intangible is acquired in a transaction to which section 332, 351, 361, 721, 731, 1031, or 1033 of the Code applies (or any transaction between members of the same affiliated group during any taxable year for which a consolidated return is filed),[147] the transferee is to be treated as the transferor for purposes of applying this provision with respect to the amount of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

For example, assume that an individual owns an amortizable section 197 intangible that has been amortized under section 197 for 4 full years and has a remaining unamortized basis of $300,000. In addition, assume that the individual exchanges the asset and $100,000 for a like-kind amortizable section 197 intangible in a transaction to which section 1031 applies. Under the bill, $300,000 of the basis of the acquired amortizable section 197 intangible is to be amortized over the 10 years remaining in the original 14-year amortization period for the transferred asset and the other $100,000 of basis is to

[145] For this purpose, the abandonment of a section 197 intangible or any other event that renders a section 197 intangible worthless is to be considered a disposition of a section 197 intangible.

[146] These special rules do not apply to a section 197 intangible that is separately acquired (i.e., a section 197 intangible that is acquired other than in a transaction or a series of related transactions that involve the acquisition of other section 197 intangibles). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible. In no event, however, is the termination or worthlessness of a portion of a section 197 intangible to be considered the disposition of a separately acquired section 197 intangible. For example, the termination of one or more customers from an acquired customer list or the worthlessness of some information from an acquired data base is not to be considered the disposition of a separately acquired section 197 intangible.

[147] The termination of a partnership under section 708(b)(1)(B) of the Code is a transaction to which this rule applies. In such a case, the basis applies only to the extent that the adjusted basis of the section 197 intangibles before the termination exceeds the adjusted basis of the section 197 intangibles after the termination. (See the example below in the discussion of "Treatment of certain partnership transactions.")

be amortized over the 14-year period specified in the bill. [148]

Treatment of certain partnership transactions.—Generally, consistent with the rules described above for certain nonrecognition transactions, a transaction in which a taxpayer acquires an interest in an intangible held through a partnership (either before or after the transaction) will be treated as an acquisition to which the bill applies only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for such intangible. [149]

For example, assume that A, B and C each contribute $700 for equal shares in partnership P, which on January 1, 1994, acquires as its sole asset an amortizable section 197 intangible for $2,100. Assume that on January 1, 1998, (1) the sole asset of P is the intangible acquired in 1994, (2) the intangible has an unamortized basis of $1,500 and A, B, and C each have a basis of $500 in their partnership interests, and (3) D (who is not related to A, B, or C) acquires A's interest in P for $800. Under the bill, if there is no section 754 election in effect for 1998, there will be no change in the basis or amortization of the intangible and D will merely step into the shoes of A with respect to the intangible. D's share of the basis in the intangible will be $500, which will be amortized over the 10 years remaining in the amortization period for the intangible.

On the other hand, if a section 754 election is in effect for 1998, then D will be treated as having an $800 basis for its share of P's intangible. Under section 197, D's share of income and loss will be determined as if P owns two intangible assets. D will be treated as having a basis of $500 in one asset, which will continue to be amortized over the 10 remaining years of the original 14-year life. With respect to the other asset, D will be treated as having a basis of $300 (the amount of step-up obtained by D under section 743 as a result of the section 754 election) which will be amortized over a 14-year period starting with January of 1998. B and C will each continue to share equally in a $1,000 basis in the intangible and amortize that amount over the remaining 10-year life.

As an additional example, assume the same facts as described above, except that D acquires both A's and B's interests in P for $1,600. Under section 708, the transaction is treated as if P is liquidated immediately after the transfer, with C and D each receiving their pro rata share of P's assets which they then immediately contribute to a new partnership. The distributions in liquidation are governed by section 731. Under the bill, C's interest in the intangible will be treated as having a $500 basis, with a remaining amortization period of 10 years. D will be treated as having an interest in two assets: one with a basis of $1,000 and a remaining amortization period of 10 years, and the other with a basis of $600 and a new amortization period of 14 years.

As discussed more fully below, the bill also changes the treatment of payments made in liquidation of the interest of a deceased or retired partner in exchange for goodwill. Except in the case of payments made on the retirement or death of a general partner of a partnership for which capital is not a material income-producing factor, such payments will not be treated as a distribution of partnership income. Under the bill, however, if the partnership makes an election under section 754, section 734 will generally provide the partnership the benefit of a stepped-up basis for the retiring or deceased partner's share of partnership goodwill and an amortization deduction for the increase in basis under section 197.

For example, using the facts from the preceding examples, assume that on January 1, 1998, A retires from the partnership in exchange for a payment from the partnership of $800, all of which is in exchange for A's interest in the intangible asset owned by P. Under the bill, if there is a section 754 election in effect for 1998, P will be treated as having two amortizable section 197 intangibles: one with a basis of $1,500 and a remaining life of 10 years, and the other with a basis of $300 and a new life of 14 years.

Treatment of certain reinsurance transactions.—The bill applies to any insurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction). [150] The amount taken into account as the adjusted basis of such a section 197 intangible, however, is to equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under the assumption reinsurance transaction, [151] over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under the assumption reinsurance transaction. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an assumption reinsurance transaction is to be amortized over the period specified in section 848 of the Code.

Treatment of amortizable section 197 intangible as depreciable property.—For purposes of chapter 1 of the Internal Revenue Code, an amortizable section 197 intangible is to be treated as property of a character which is subject to the allowance for depreciation provided in section 167. Thus, for example, an amortizable section 197 intangible is not a capital asset for purposes of section 1221 of the Code, but an amortizable section 197 intangible held for more than one year generally qualifies as property used in a trade or business for purposes of section 1231 of the Code. As further examples, an amortizable section 197 intangible is to constitute section 1245 property, and section 1239 of the Code is to apply to any gain recognized upon the sale or exchange of an amortizable section 197 intangible, directly or indirectly, between related persons.

Treatment of certain amounts that are properly taken into account in determining the cost of property that is not a section 197 intangible.—The bill does not apply to any amount that is properly taken into account under present law in determining the cost of property that is not a section 197 intangible. Thus, for example, no portion of the cost of acquiring real property that is held for the production of rental income (for example, an office building, apartment building or shopping center) is to be taken into account under the bill (i.e., no goodwill, going concern value or any other section 197 intangible is to

[148] No inference is intended whether any asset treated as a section 197 intangible under the bill is eligible for like kind exchange treatment.

[149] This discussion is subject to the application of the anti-churning rules which are discussed below

[150] An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an assumption reinsurance transaction is to include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code.

[151] The amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction is to be determined under the principles of present law (See Treas. Reg. sec. 1.817-4(d)(2).)

arise in connection with the acquisition of such real property. Instead, the entire cost of acquiring such real property is to be included in the basis of the real property and is to be recovered under the principles of present law applicable to such property.

Modification of purchase price allocation and reporting rules for certain asset acquisitions.—Sections 338(b)(5) and 1060 of the Code authorize the Treasury Department to promulgate regulations that provide for the allocation of purchase price among assets in the case of certain asset acquisitions. Under regulations that have been promulgated pursuant to this authority, the purchase price of an acquired trade or business must be allocated among the assets of the trade or business using the "residual method."

Under the residual method specified in the Treasury regulations, all assets of an acquired trade or business are divided into the following four classes: (1) Class I assets, which generally include cash and cash equivalents; (2) Class II assets, which generally include certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) Class III assets, which generally include all assets other than those included in Class I, II, or IV (generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete, and other amortizable intangible assets); and (4) Class IV assets, which include intangible assets in the nature of goodwill or going concern value. The purchase price of an acquired trade or business (as first reduced by the amount of the assets included in Class I) is allocated to the assets included in Class II and Class III based on the value of the assets included in each class. To the extent that the purchase price (as reduced by the amount of the assets in Class I) exceeds the value of the assets included in Class II and Class III, the excess is allocable to assets included in Class IV.

It is expected that the present Treasury regulations which provide for the allocation of purchase price in the case of certain asset acquisitions will be amended to reflect the fact that the bill allows an amortization deduction with respect to intangible assets in the nature of goodwill and going concern value. It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies.

Section 1060 also authorizes the Treasury Department to require the transferor and transferee in certain asset acquisitions to furnish information to the Treasury Department concerning the amount of any purchase price that is allocable to goodwill or going concern value. The bill provides that the information furnished to the Treasury Department with respect to certain asset acquisitions is to specify the amount of purchase price that is allocable to amortizable section 197 intangibles rather than the amount of purchase price that is allocable to goodwill or going concern value. In addition, it is anticipated that the Treasury Department will exercise its existing regulatory authority to require taxpayers to furnish such additional information as may be necessary or appropriate to carry out the provisions of the bill, including the amount of purchase price that is allocable to intangible assets that are not amortizable section 197 intangibles.[152]

General regulatory authority.—The Treasury Department is authorized to prescribe such regulations as may be appropriate to carry out the purposes of the bill including such regulations as may be appropriate to prevent avoidance of the purposes of the bill through related persons or otherwise. It is anticipated that the Treasury Department will exercise its regulatory authority where appropriate to clarify the types of intangible property that constitute section 197 intangibles.

Study.—The Treasury Department is directed to conduct a continuing study of the implementation and effects of the bill, including effects on merger and acquisition activities (including hostile takeovers and leveraged buyouts). It is expected that the study will address effects of the legislation on the pricing of acquisitions and on the reported values of different types of intangibles (including goodwill). The Treasury Department is to report the initial results of such study as expeditiously as possible and no later than December 31, 1994. The Treasury Department is to provide additional reports annually thereafter.

Report regarding backlog of pending cases.—The purpose of the provision is to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit and litigation is a matter of great concern, and any principles established in such cases will no longer have precedential value due to the provision. Therefore, the Internal Revenue Service is urged in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedient and balanced manner, the Internal Revenue Service is strongly encouraged to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. However, no inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under present law.

The Treasury Department is required to report annually to the House Ways and Means Committee and the Senate Finance Committee, regarding the volume of pending disputes in audit and litigation involving the amortization of intangibles and the progress made in resolving such disputes. It is expected that the report will also address the effect of the provision on the volume and nature of disputes regarding the amortization of intangibles. The first report is to be made no later than December 31, 1995.

Effective Date.—The provision generally applies to property acquired after the date of enactment of the bill. As more fully described below, however, a taxpayer may elect to apply the bill to all property acquired after July 25, 1991. In addition, a taxpayer that does not make this election may elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill pursuant to a binding written contract in effect on the date of enactment of the bill and at all times thereafter until the property is acquired. Finally, special "anti-churning" rules may apply to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Election to apply bill to property acquired after July 25, 1991.—A taxpayer may elect to apply the bill to all property acquired by the taxpayer after July 25, 1991. If a taxpayer makes this election, the bill also applies to all property acquired after July 25, 1991, by any taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)) of the Code) at any time during the

[152] There is no intention to codify any aspect of the existing regulations under section 1060 or other provisions. Furthermore, it is expected that the Treasury Department will review the operation of the regulations under sections 1060 and 338 in light of new section 197.

period that began on November 22, 1991, and that ends on the date that the election is made. [153]

The election is to be made at such time and in such manner as may be specified by the Treasury Department, [154] and the election may be revoked only with the consent of the Treasury Department.

Elective binding contract exception.—A taxpayer may also elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill if the property is acquired pursuant to a binding written contract that was in effect on the date of enactment of the bill and at all times thereafter until the property is acquired. This election may not be made by any taxpayer that is subject to either of the elections described above that apply the provisions of the bill to property acquired before the date of enactment of the bill.

The election is to be made at such time and in such manner as may be specified by the Treasury Department, [155] and the election may be revoked only with the consent of the Treasury Department.

Anti-churning rules.—Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill [156] may not be amortized as an amortizable section 197 intangible if: (1) the section 197 intangible is acquired by a taxpayer after the date of enactment of the bill; and (2) either (a) the taxpayer or a related person held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill; (b) the taxpayer acquired the intangible from a person that held such intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill. The anti-churning rules, however, do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

For purposes of the anti-churning rules, a person is related to another person if: (1) the person bears a relationship to that person which would be specified in section 267(b)(1) or 707(b)(1) of the Code if those sections were amended by substituting 20 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code). A person is treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

In addition, in determining whether the anti-churning rules apply with respect to any increase in the basis of partnership property under section 732, 734, or 743 of the Code, the determinations are to be made at the partner level and each partner is to be treated as having owned or used the partner's proportionate share of the partnership property. Thus, for example, the anti-churning rules do not apply to any increase in the basis of partnership property that occurs upon the acquisition of an interest in a partnership that has made a section 754 election if the person acquiring the partnership interest is not related to the person selling the partnership interest. [157]

These "anti-churning" rules are not to apply to any section 197 intangible that is acquired from a person with less than a 50-percent relationship to the acquirer to the extent that: (1) the seller recognizes gain on the transaction with respect to such intangible; and (2) the seller agrees, notwithstanding any other provision of the Code, to pay a tax on such gain which, when added to any other Federal income tax imposed on such gain, equals the product of such gain and the highest rate of tax imposed by section 1 or 11 of the Code, whichever is applicable. The seller is treated as satisfying the second requirement if the excess of (1) the total tax liability for the year of the transaction over (2) what its tax liability for such year would have been had the sale of the intangible (but not the remainder of the transaction) been excluded from the computation equals or exceeds the product of the gain on that asset times the relevant maximum rate.

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[153] However, with certain exceptions, an amortization deduction is not to be allowed under the bill for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991, (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. See below for a more detailed description of these "anti-churning" rules.

[154] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the data of enactment of the bill.

[155] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the data of enactment of the bill.

[156] Amounts that are properly deductible pursuant to section 1253 under present law are to be treated for purposes of the anti-churning provision as amounts for which depreciation or amortization is allowable under present law.

[157] In addition to these rules, it is anticipated that rules similar to the anti-churning rules under section 168 of the Code will apply in determining whether persons are related. (See Prop. Treas. Reg. 1.168-4 (February 16, 1984).) For example, it is anticipated that a corporation, partnership, or trust that owned or used property at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and that is no longer in existence will be considered to be in existence for purposes of determining whether the taxpayer that acquired the property is related to such corporation, partnership, or trust.

As a further example, it is anticipated that in the case of a transaction to which section 338 of the Code applies, the corporation that is treated as selling its assets will not to be considered related to the corporation that is treated as purchasing the assets if at least 80 percent of the stock of the corporation that is treated as selling its assets is acquired by purchase after July 25, 1991.

The bill also contains a general anti-abuse rule that applies to any section 197 intangible that is acquired by a taxpayer from another person. Under this rule, a section 197 intangible may not be amortized under the provisions of the bill if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (1) avoid the requirement that the intangible be acquired after the date of enactment of the bill or (2) avoid any of the anti-churning rules described above that are applicable to goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill.

Finally, the special rules described above that apply in the case of transactions described in section 332, 351, 361, 721, 731, 1031, or 1033 of the Code also apply for purposes of the effective date. Consequently, if the transferor of any section 197 property is not allowed an amortization deduction with respect to such property under this provision, then the transferee is not allowed an amortization deduction under this provision to the extent of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor. In addition, this provision is to apply to any subsequent transfers of any such property in a transaction described in section 332, 351, 361, 721, 731, 1031, or 1033.—**House Committee Report.**

Conference Agreement.—The conference agreement follows the House bill, deleting the statutory requirements of reports from the Treasury Department and with the following additional modifications:

Period of amortization.—The straight line amortization period for an amortizable section 197 intangible is 15 years rather than 14 years.

Treasury regulatory authority regarding rights of fixed duration or amount.—As a conforming amendment to the change in amortization period, under the conference agreement the Treasury regulatory authority regarding rights of fixed duration or amount applies to rights that have a fixed duration of less than 15 years (rather than 14 years).

Purchased mortgage servicing rights.—The conference agreement follows the Senate bill in excluding purchased mortgage servicing rights (not acquired in connection with the acquisition of a trade or business or substantial portion thereof) from the definition of a section 197 intangible. Any depreciation deduction allowable with respect to such excluded rights must be computed on a straight line basis over a period of 9 years (108 months).[33]

Technical correction regarding losses on covenants not to compete.—The conference agreement contains a technical correction conforming the statute to both the House and Senate committee reports regarding the amortization of covenants not to compete. The correction provides that a covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) shall not be considered to have been disposed of or to have become worthless until the disposition or worthlessness of all interests in the trade or business or substantial portion thereof that was directly or indirectly acquired in connection with such covenant (or other arrangement).

Thus, for example, in the case of an indirect acquisition of a trade or business (e.g., through the acquisition of stock that is not treated as an asset acquisition), it is clarified that a covenant not to compete (or other arrangement) entered into in connection with the indirect acquisition cannot be written off faster than on a straight-line basis over 15 years (even if the covenant or other arrangement expires or otherwise becomes worthless) unless all the trades or businesses indirectly acquired (e.g., acquired through such stock interest) are also disposed of or become worthless.

Modification of related party rule for purposes of the July 25, 1991 election.—The conference agreement modifies the rules regarding the effect of an election on certain related parties, in order to reflect the passage of time since the election was originally proposed (H. Res. 292, introduced November 22, 1991).

The conference agreement provides that an election by a taxpayer affects all property acquired by that taxpayer since July 25, 1991, and also affects all property acquired since that date by parties that are related to the taxpayer at any time between August 2, 1993 (rather than November 22, 1991) and the date of the election.

Consistent with the operation of the consolidated return rules, for this purpose it is intended that any property acquired after July 25, 1991 by an entity that is a member of an affiliated group filing a consolidated return at the time of such acquisition is treated as property acquired by the taxpayer group filing such return for purposes of any election by that taxpayer group.

An election by an affiliated group filing a consolidated return would not force an election to be made by an acquirer of a former group member, even if such acquirer would normally continue the treatment of such former group member's assets (e.g., an acquirer in a transaction that does not affect the inside basis of the assets of the former group member). Similarly, a failure by the former group to make an election would not affect the ability of the former group member, or a new acquirer that is related to such member on the date of the election, to make an election that would affect the post-July 25, 1991 intangible asset acquisitions of that former group member (including such intangible asset acquisitions made while it was a member of the former group).[34]

The conferees expect that the Treasury Department will provide rules regarding appropriate adjustments, if any, to be made where property acquired after July 25, 1991 has been transferred from one related party group to another in a transaction that would not involve a change in asset basis and one or both groups indepen-

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[33] Consistent with both the House and Senate bills, purchased mortgage servicing rights are not depreciable to the extent that the rights are stripped coupons under section 1286 of the Code. To the extent that the rights are stripped coupons under section 1286 of the Code, they will not be amortized on a straight line basis over 108 months. See Rev. Rul. 91-46, 1991-2 C.B. 358.

[34] For example, assume the following facts. Corporation P is the parent of an affiliated group filing a consolidated return that includes subsidiary S. The P group files its consolidated return on the basis of the calendar year. S acquires certain intangible assets on August 1, 1991. The stock of S is sold to corporation X on December 31, 1992, in a transaction in which S's adjusted basis in its assets is not changed. Corporation X is also the parent of an affiliated group filing a consolidated return that now includes S. S remains in the X group. Under the conference agreement, if the X group makes the July 25, 1991 election, such election does not require the P group also to make the election. If the P group makes the July 25, 1991 election, the election will affect the amortization deductions allowed on the P group's 1991 and 1992 consolidated returns with respect to the assets acquired by S on August 1, 1991. Such election does not require the X group also to make the election.

dently make a July 25, 1991 election that would affect the amortization of such property. [35]

Reports regarding backlog of pending cases and implementation and effects of the bill.—The conferees reiterate the intended purpose of the provision, as stated in both the House and Senate reports, to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit and litigation is a matter of great concern to the conferees; and any principles established in such cases will no longer have precedential value due to the provision contained in the conference agreement. Therefore, the conferees urge the Internal Revenue Service in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedited and balanced manner, the conferees strongly encourage the Internal Revenue Service to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. However, no inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under present law.

The conferees intend that the Treasury Department report annually to the House Ways and Means Committee and the Senate Finance Committee regarding the volume of pending disputes in audit and litigation involving the amortization of intangibles and the progress made in resolving disputes. It is intended that the report also address the effects of the provision on the volume and nature of disputes regarding the amortization of intangibles. It is intended that the first such report shall be made no later than December 31, 1994.

The conferees also intend that the Treasury Department conduct a continuing study of the implementation and effects of the bill, including effects on merger and acquisition activities (including hostile takeovers and leveraged buyouts). It is expected that the study will address effects of the legislation on the pricing of acquisitions and on the reported values of different types of intangibles (including goodwill). It is intended that the Treasury Department will report the initial results of such study as expeditiously as possible and no later than December 31, 1994. The Treasury Department is expected to provide additional reports annually thereafter.—**Conference Committee Report.**

● *Temporary Regulations*

[¶ 12,451] § 1.197-1T. **Certain elections for intangible property (temporary).**—(a) *In general.* This section provides rules for making the two elections under section 13261 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93). Paragraph (c) of this section provides rules for making the section 13261(g)(2) election (the retroactive election) to apply the intangibles provisions of OBRA '93 to property acquired after July 25, 1991, and on or before August 10, 1993 (the date of enactment of OBRA '93). Paragraph (d) of this section provides rules for making the section 13261(g)(3) election (binding contract election) to apply prior law to property acquired pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the date of acquisition. The provisions of this section apply only to property for which an election is made under paragraph (c) or (d) of this section.

(b) *Definitions and special rules*—(1) *Intangibles provisions of OBRA '93.* The intangibles provisions of OBRA '93 are sections 167(f) and 197 of the Internal Revenue Code (Code) and all other pertinent provisions of section 13261 of OBRA '93 (e.g., the amendment of section 1253 in the case of a franchise, trademark, or trade name).

(2) *Transition period property.* The transition period property of a taxpayer is any property that was acquired by the taxpayer after July 25, 1991, and on or before August 10, 1993.

(3) *Eligible section 197 intangibles.* The eligible section 197 intangibles of a taxpayer are any section 197 intangibles that—

(i) Are transition period property; and

(ii) Qualify as amortizable section 197 intangibles (within the meaning of section 197(c)) if an election under section 13261(g)(2) of OBRA '93 applies.

(4) *Election date.* The election date is the date (determined after application of section 7502(a)) on which the taxpayer files the original or amended return to which the election statement described in paragraph (e) of this section is attached.

(5) *Election year.* The election year is the taxable year of the taxpayer that includes August 10, 1993.

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[35] For example, such rules would apply if a corporation that is a member of an affiliated group filing a consolidated return acquires property after July 25, 1991 and then, before August 2, 1993 becomes a member of another group in a transaction that does not affect the basis of that corporation's assets. In such a case, the first group could make the election for periods when the corporation was included in that group's consolidated return. In addition, the second group could make the election because the corporation was related to the second group on August 2, 1993.

(6) *Common control.* A taxpayer is under common control with the electing taxpayer if, at any time after August 2, 1993, and on or before the election date (as defined in paragraph (b)(4) of this section), the two taxpayers would be treated as a single taxpayer under section 41(f)(1)(A) or (B).

(7) *Applicable convention for sections 197 and 167(f) intangibles.* For purposes of computing the depreciation or amortization deduction allowable with respect to transition period property described in section 167(f)(1) or (3) or with respect to eligible section 197 intangibles—

(i) Property acquired at any time during the month is treated as acquired as of the first day of the month and is eligible for depreciation or amortization during the month; and

(ii) Property is not eligible for depreciation or amortization in the month of disposition.

(8) *Application to adjustment to basis of partnership property under section 734(b) or 743(b).* Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property) will be taken into account under this section by a partner as if the increased portion of the basis were attributable to the partner's acquisition of the underlying partnership property on the date the distribution or transfer occurs. For example, if a section 754 election is in effect and, as a result of its acquisition of a partnership interest, a taxpayer obtains an increased basis in an intangible held through the partnership, the increased portion of the basis in the intangible will be treated as an intangible asset newly acquired by that taxpayer on the date of the transaction.

(9) *Former member.* A former member of a consolidated group is a corporation that was a member of the consolidated group at any time after July 25, 1991, and on or before August 2, 1993, but that is not under common control with the common parent of the group for purposes of paragraph (c)(1)(ii) of this section.

(c) *Retroactive election*—(1) *Effect of election*—(i) *On taxpayer.* Except as provided in paragraph (c)(1)(v) of this section, if a taxpayer makes the retroactive election, the intangibles provisions of OBRA '93 will apply to all the taxpayer's transition period property. Thus, for example, section 197 will apply to all the taxpayer's eligible section 197 intangibles.

(ii) *On taxpayers under common control.* If a taxpayer makes the retroactive election, the election applies to each taxpayer that is under common control with the electing taxpayer. If the retroactive election applies to a taxpayer under common control, the intangibles provisions of OBRA '93 apply to that taxpayer's transition period property in the same manner as if that taxpayer had itself made the retroactive election. However, a retroactive election that applies to a non-electing taxpayer under common control is not treated as an election by that taxpayer for purposes of re-applying the rule of this paragraph (c)(1)(ii) to any other taxpayer.

(iii) *On former members of consolidated group.* A retroactive election by the common parent of a consolidated group applies to transition period property acquired by a former member while it was a member of the consolidated group and continues to apply to that property in each subsequent consolidated or separate return year of the former member.

(iv) *On transferred assets*—(A) *In general.* If property is transferred in a transaction described in paragraph (c)(1)(iv)(C) of this section and the intangibles provisions of OBRA '93 applied to such property in the hands of the transferor, the property remains subject to the intangibles provisions of OBRA '93 with respect to so much of its adjusted basis in the hands of the transferee as does not exceed its adjusted

basis in the hands of the transferor. The transferee is not required to apply the intangibles provisions of OBRA '93 to any other transition period property that it owns, however, unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(B) *Transferee election.* If property is transferred in a transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section and the transferee makes the retroactive election, the transferor is not required to apply the intangibles provisions of OBRA '93 to any of its transition period property (including the property transferred to the transferee in the transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section), unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(C) *Transactions covered.* This paragraph (c)(1)(iv) applies to—

(*1*) Any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033; and

(*2*) Any transaction between corporations that are members of the same consolidated group immediately after the transaction.

(D) *Exchanged basis property.* In the case of a transaction involving exchanged basis property (e.g., a transaction subject to section 1031 or 1033 —

(*1*) Paragraph (c)(1)(iv)(A) of this section shall not apply; and

(*2*) If the intangibles provisions of OBRA '93 applied to the property by reference to which the exchanged basis is determined (the predecessor property), the exchanged basis property becomes subject to the intangibles provisions of OBRA '93 with respect to so much of its basis as does not exceed the predecessor property's basis.

(E) *Acquisition date.* For purposes of paragraph (b)(2) of this section (definition of transition period property), property (other than exchanged basis property) acquired in a transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section generally is treated as acquired when the transferor acquired (or was treated as acquiring) the property (or predecessor property). However, if the adjusted basis of the property in the hands of the transferee exceeds the adjusted basis of the property in the hands of the transferor, the property, with respect to that excess basis, is treated as acquired at the time of the transfer. The time at which exchanged basis property is considered acquired is determined by applying similar principles to the transferee's acquisition of predecessor property.

(v) *Special rule for property of former member of consolidated group* —(A) *Intangibles provisions inapplicable for certain periods.* If a former member of a consolidated group makes a retroactive election pursuant to paragraph (c)(1)(i) of this section or if an election applies to the former member under the common control rule of paragraph (c)(1)(ii) of this section, the intangibles provisions of OBRA '93 generally apply to all transition period property of the former member. The intangibles provisions of OBRA '93 do not apply, however, to the transition period property of a former member (including a former member that makes or is bound by a retroactive election) during the period beginning immediately after July 25, 1991, and ending immediately before the earlier of—

(*1*) The first day after July 25, 1991, that the former member was not a member of a consolidated group; or

(*2*) The first day after July 25, 1991, that the former member was a member of a consolidated group that is otherwise required to apply the intangibles provisions of OBRA '93 to its transition period property (e.g., because the common control election under paragraph (c)(1)(ii) of this section applies to the group).

(B) *Subsequent adjustments.* See paragraph (c)(5) of this section for adjustments when the intangibles provisions of OBRA '93 first apply to the transition period property of the former member after the property is acquired.

(2) *Making the election*—(i) *Partnerships, S corporations, estates, and trusts* Except as provided in paragraph (c)(2)(ii) of this section, in the case of transition period property of a partnership, S corporation, estate, or trust, only the entity may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(ii) *Partnerships for which a section 754 election is in effect.* In the case of increased basis that is treated as transition period property of a partner under paragraph (b)(8) of this section, only that partner may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(iii) *Consolidated groups.* An election by the common parent of a consolidated group applies to members and former members as described in paragraphs (c)(1)(ii) and (iii) of this section. Further, for purposes of paragraph (c)(1)(ii) of this section, an election by the common parent is not treated as an election by any subsidiary member. A retroactive election cannot be made by a corporation that is a subsidiary member of a consolidated group on August 10, 1993, but an election can be made on behalf of the subsidiary member under paragraph (c)(1)(ii) of this section (e.g., by the common parent of the group). See paragraph (c)(1)(iii) of this section for rules concerning the effect of the common parent's election on transition period property of a former member.

(3) *Time and manner of election*—(i) *Time.* In general, the retroactive election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before [*INSERT THE DATE THAT IS 30 DAYS AFTER PUBLICATION OF THESE REGULATIONS IN THE FEDERAL REGISTER*], the election may be made by amending that return no later than [*INSERT THE DATE THAT IS 180 DAYS AFTER PUBLICATION OF THESE REGULATIONS IN THE FEDERAL REGISTER*].

(ii) *Manner.* The retroactive election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year. In addition, the taxpayer must—

(A) Amend any previously filed return when required to do so under paragraph (c)(4) of this section; and

(B) Satisfy the notification requirements of paragraph (c)(6) of this section.

(iii) *Effect of nonconforming elections.* An attempted election that does not satisfy the requirements of this paragraph (c)(3) (including an attempted election made on a return for a taxable year prior to the election year) is not valid.

(4) *Amended return requirements*—(i) *Requirements.* A taxpayer subject to this paragraph (c)(4) must amend all previously filed income tax returns as necessary to conform the taxpayer's treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93. See paragraph (c)(5) of this section for certain adjustments that may be required on the amended returns required under this paragraph (c)(4) in the case of certain consolidated group member dispositions and tax-free transactions.

(ii) *Applicability.* This paragraph (c)(4) applies to a taxpayer if—

(A) The taxpayer makes the retroactive election; or

(B) Another person's retroactive election applies to the taxpayer or to any property acquired by the taxpayer.

(5) *Adjustment required with respect to certain consolidated group member dispositions and tax-free transactions*—(i) *Application.* This paragraph (c)(5) applies to transition period property if the intangibles provisions of OBRA '93 first apply to the property while it is held by the taxpayer but do not apply to the property for some period (the "interim period") after the property is acquired (or considered acquired) by the taxpayer. For example, this paragraph (c)(5) may apply to transition period property held by a former member of a consolidated group if a retroactive election is made by or on behalf of the former member but is not made by the consolidated group. See paragraph (c)(1)(v) of this section.

(ii) *Required adjustment to income.* If this paragraph (c)(5) applies, an adjustment must be taken into account in computing taxable income of the taxpayer for the taxable year in which the intangibles provisions of OBRA '93 first apply to the property. The amount of the adjustment is equal to the difference for the transition period property between—

(A) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) would have been permitted if the intangibles provisions of OBRA '93 applied to the property during the interim period; and

(B) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) claimed during that interim period.

(iii) *Required adjustment to basis.* The taxpayer also must make a corresponding adjustment to the basis of its transition period property to reflect any adjustment to taxable income with respect to the property under this paragraph (c)(5).

(6) *Notification requirements*—(i) *Notification of commonly controlled taxpayers.* A taxpayer that makes the retroactive election must provide written notification of the retroactive election (on or before the election date) to each taxpayer that is under common control with the electing taxpayer.

(ii) *Notification of certain former members, former consolidated groups, and transferees.* This paragraph (c)(6)(ii) applies to a common parent of a consolidated group that makes or is notified of a retroactive election that applies to transition period property of a former member, a corporation that makes or is notified of a retroactive election that affects any consolidated group of which the corporation is a former member, or a taxpayer that makes or is notified of a retroactive election that applies to transition period property the taxpayer transfers in a transaction described in paragraph (c)(1)(iv)(C) of this section. Such common parent, former member, or transferor must provide written notification of the retroactive election to any affected former member, consolidated group, or transferee. The written notification must be provided on or before the election date in the case of an election by the common parent, former member, or transferor, and within 30 days of the election date in the case of an election by a person other than the common parent, former member, or transferor.

(7) *Revocation.* Once made, the retroactive election may be revoked only with the consent of the Commissioner.

(8) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. (i) *X* is a partnership with 5 equal partners, *A* through *E*. *X* acquires in 1989, as its sole asset, intangible asset *M*. *X* has a section 754 election in effect for all relevant years. *F*, an unrelated individual, purchases *A*'s entire interest in the *X* partnership in January 1993 for $700. At the time of *F*'s purchase, *X*'s inside basis for *M* is $2,000, and its fair market value is $3,500.

(ii) Under section 743(b), *X* makes an adjustment to increase *F*'s basis in asset *M* by $300, the difference between the allocated purchase price and *M*'s inside

basis ($700 - $400 = $300). Under paragraphs (b)(8) and (c)(2)(ii) of this section, if *F* makes the retroactive election, the section 743(b) basis increase of $300 in *M* is an amortizable section 197 intangible even though asset *M* is not an amortizable section 197 intangible in the hands of *X*. *F's* increase in the basis of asset *M* is amortizable over 15 years beginning with the month of *F*'s acquisition of the partnership interest. With respect to the remaining $400 of basis, *F* is treated as stepping into *A*'s shoes and continues *A*'s amortization (if any) in asset *M*. *F*'s retroactive election applies to all other intangibles acquired by *F* or a taxpayer under common control with *F*.

Example 2. *A*, a calendar year taxpayer, is under common control with *B*, a June 30 fiscal year taxpayer. *A* files its original election year Federal income tax return on March 15, 1994, and does not make either the retroactive election or the binding contract election. *B* files its election year tax return on September 15, 1994, and makes the retroactive election. *B* is required by paragraph (c)(6)(i) of this section to notify *A* of its election. Even though *A* had already filed its election year return, *A* is bound by *B*'s retroactive election under the common control rules. Additionally, if *A* had made a binding contract election, it would have been negated by *B*'s retroactive election. Because of *B*'s retroactive election, *A* must comply with the requirements of this paragraph (c), and file amended returns for the election year and any affected prior years as necessary to conform the treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93.

Example 3. (i) *P* and *Y*, calendar year taxpayers, are the common parents of unrelated calendar year consolidated groups. On August 15, 1991, *S*, a subsidiary member of the *P* group, acquires a section 197 intangible with an unadjusted basis of $180. Under prior law, no amortization or depreciation was allowed with respect to the acquired intangible. On November 1, 1992, a member of the *Y* group acquires the *S* stock in a taxable transaction. On the *P* group's 1993 consolidated return, *P* makes the retroactive election. The *P* group also files amended returns for its affected prior years. *Y* does not make the retroactive election for the *Y* group.

(ii) Under paragraph (c)(1)(iii) of this section, a retroactive election by the common parent of a consolidated group applies to all transition period property acquired by a former member while it was a member of the group. The section 197 intangible acquired by *S* is transition period property that *S*, a former member of the *P* group, acquired while a member of the *P* group. Thus, *P*'s election applies to the acquired asset. *P* must notify *S* of the election pursuant to paragraph (c)(6)(ii) of this section.

(iii) *S* amortizes the unadjusted basis of its eligible section 197 intangible ($180) over the 15-year amortization period using the applicable convention beginning as of the first day of the month of acquisition (August 1, 1991). Thus, the *P* group amends its 1991 consolidated tax return to take into account $5 of amortization ($180/15 years × 5/12 year = $5) for *S*.

(iv) For 1992, *S* is entitled to $12 of amortization ($180/15). Assume that under § 1.1502-76, $10 of *S*'s amortization for 1992 is allocated to the *P* group's consolidated return and $2 is allocated to the *Y* group's return. The *P* group amends its 1992 consolidated tax return to reflect the $10 deduction for *S*. The *Y* group must amend its 1992 return to reflect the $2 deduction for *S*.

Example 4. (i) The facts are the same as in *Example 3*, except that the retroactive election is made for the *Y* group, not for the *P* group.

(ii) The *Y* group amends its 1992 consolidated return to claim a section 197 deduction of $2 ($180/15 years × 2/12 year = $2) for *S*.

(iii) Under paragraph (c)(1)(ii) of this section, the retroactive election by *Y* applies to all transition period property acquired by *S*. However, under paragraph (c)(1)(v)(A) of this section, the intangibles provisions of OBRA '93 do not apply to *S*'s

transition period property during the period when it held such property as a member of *P* group. Instead, these provisions become applicable to *S*'s transition period property beginning on November 1, 1992, when *S* becomes a member of *Y* group.

(iv) Because the *P* group did not make the retroactive election, there is an interim period during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by *S*. Thus, under paragraph (c)(5) of this section, the *Y* group must take into account in computing taxable income in 1992 an adjustment equal to the difference between the section 197 deduction that would have been permitted if the intangibles provisions of OBRA '93 applied to the property for the interim period (i.e., the period for which *S* was included in the *P* group's 1991 and 1992 consolidated returns) and any amortization or depreciation deductions claimed by *S* for the transferred intangible for that period. The retroactive election does not affect the *P* group, and the *P* group is not required to amend its returns.

Example 5. The facts are the same as in *Example 3*, except that both *P* and *Y* make the retroactive election. *P* must notify *S* of its election pursuant to paragraph (c)(6)(ii) of this section. Further, both the *P* and *Y* groups must file amended returns for affected prior years. Because there is no period of time during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by *S*, the *Y* group is permitted no adjustment under paragraph (c)(5) of this section for the asset.

(d) *Binding contract election*—(1) *General rule*—(i) *Effect of election.* If a taxpayer acquires property pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the acquisition (an eligible acquisition) and makes the binding contract election with respect to the contract, the law in effect prior to the enactment of OBRA '93 will apply to all property acquired pursuant to the contract. A separate binding contract election must be made with respect to each eligible acquisition to which the law in effect prior to the enactment of OBRA '93 is to apply.

(ii) *Taxpayers subject to retroactive election.* A taxpayer may not make the binding contract election if the taxpayer or a person under common control with the taxpayer makes the retroactive election under paragraph (c) of this section.

(iii) *Revocation.* A binding contract election, once made, may be revoked only with the consent of the Commissioner.

(2) *Time and manner of election*—(i) *Time.* In general, the binding contract election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before [*INSERT THE DATE THAT IS 30 DAYS AFTER PUBLICATION OF THESE REGULATIONS IN THE FEDERAL REGISTER*], the election may be made by amending that return no later than [*INSERT THE DATE THAT IS 180 DAYS AFTER PUBLICATION OF THESE REGULATIONS IN THE FEDERAL REGISTER*].

(ii) *Manner.* The binding contract election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year.

(iii) *Effect of nonconforming election.* An attempted election that does not satisfy the requirements of this paragraph (d)(2) is not valid.

(e) *Election statement*—(1) *Filing requirements.* For an election under paragraph (c) or (d) of this section to be valid, the electing taxpayer must:

(i) File (with its Federal income tax return for the election year with any affected amended returns required under paragraph (c)(4) of this section) a written election statement, as an attachment to Form 4562 (Depreciation and Amortization), that satisfies the requirements of paragraph (e)(2) of this section; and

(ii) Forward a copy of the election statement to the Statistics Branch (QAM:S:6111), IRS Ogden Service Center, ATTN: Chief, Statistics Branch, P.O. Box 9941, Ogden, UT 84409.

(2) *Content of the election statement.* The written election statement must include the information in paragraphs (e)(2)(i) through (vi) and (ix) of this section in the case of a retroactive election, and the information in paragraphs (e)(2)(i) and (vii) through (ix) of this section in the case of a binding contract election. The required information should be arranged and identified in accordance with the following order and numbering system—

(i) The name, address and taxpayer identification number (TIN) of the electing taxpayer (and the common parent if a consolidated return is filed).

(ii) A statement that the taxpayer is making the retroactive election.

(iii) Identification of the transition period property affected by the retroactive election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and the amount of depreciation, amortization, or other cost recovery under section 167 or any other provision of the Code claimed with respect to the property.

(iv) Identification of each taxpayer under common control (as defined in paragraph (b)(6) of this section) with the electing taxpayer by name, TIN, and Internal Revenue Service Center where the taxpayer's income tax return is filed.

(v) If any persons are required to be notified of the retroactive election under paragraph (c)(6) of this section, identification of such persons and certification that written notification of the election has been provided to such persons.

(vi) A statement that the transition period property being amortized under section 197 is not subject to the anti-churning rules of section 197(f)(9).

(vii) A statement that the taxpayer is making the binding contract election.

(viii) Identification of the property affected by the binding contract election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and whether any of the property is subject to depreciation under section 167 or to amortization or other cost recovery under any other provision of the Code.

(ix) The signature of the taxpayer or an individual authorized to sign the taxpayer's Federal income tax return.

(f) *Effective date.* These regulations are effective March 15, 1994. [Temporary Reg. § 1.197-1T.]

.01 Historical Comment: Adopted 3/10/94 by T.D. 8528.

[¶ 12,455] Amortization Deduction for Intangibles

● ● *CCH Explanation*

.01 In general.—The treatment of the costs attributable to the acquisition of intangible assets has been a source of considerable controversy between taxpayers and the IRS. Under prior law, an acquired intangible asset could be depreciated if held for use in a trade or business or for the production of income and if the taxpayer could demonstrate with reasonable accuracy that the intangible had a limited useful life. Goodwill was not depreciable (Reg. § 1.167(a)-3). In order to eliminate the controversy surrounding the treatment of goodwill and certain other intangibles, Code Sec. 197 was added by P.L. 103-66 to provide a single method and period for recovering the cost

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of most acquired intangibles (House Committee Report for P.L. 103-66, Revenue Reconciliation Act of 1993).

Taxpayers may deduct the ratably amortized capital costs of specified intangible assets referred to as "section 197 intangibles" over a 15-year period beginning in the month of acquisition (Code Sec. 197(a)). The 15-year amortization period applies regardless of the actual useful life of an amortizable section 197 intangible. No other depreciation or amortization deduction may be claimed on a section 197 intangible that is amortizable under this provision (Code Sec. 197(b)). However, section 197 intangibles are treated as depreciable property (Code Sec. 197(f)(7)).

Generally, section 197 intangibles are eligible for the amortization deduction if acquired after August 10, 1993, and held in connection with a trade or business or in an activity engaged in for the production of income (Code Sec. 197(c)(1)). (See .07 below for a discussion of the election to apply these rules to property acquired after July 25, 1991.) A section 197 intangible created by the taxpayer is not eligible for the amortization deduction, with certain limited exceptions, if the intangible is not created in connection with a transaction, or a series of related transactions, involving the acquisition of assets constituting a trade or business or a substantial portion of a trade or business (Code Sec. 197(c)(2)).

Amortizable basis. The amortizable basis of a section 197 intangible is its adjusted basis for purposes of determining gain (Code Sec. 197(a)). Generally, this is the amount of its cost (see ¶ 29,685.01 for a discussion of the basis rules).

The House Committee Report indicates that section 197 intangibles acquired pursuant to an asset acquisition to which Code Sec. 338 or 1060 applies should be treated as Class IV assets. (See ¶ 16,288.01 and 31,963.01 for a discussion of the rules relating to asset acquisitions.) Consequently, the purchase price of section 197 intangibles so acquired will be the amount by which the total purchase price (as reduced by the amount of Class I assets) exceeds the value of assets included in Class II and Class III.

.02 Section 197 intangible defined.—The term "section 197 intangible" is defined to mean:

(1) goodwill;

(2) going-concern value;

(3) work force in place;

(4) an information base;

(5) any patent, copyright, formula, process, design, pattern, know-how, format, or similar item;

(6) any customer-based intangible;

(7) any supplier-based intangible;

(8) any license, permit, or other right granted by a governmental unit or agency;

(9) any covenant not to compete (or similar arrangement) entered into in connection with the acquisition of a trade or business or a substantial portion of a trade or business; and

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● ● *CCH Explanation*

(10) any franchise, trademark, or tradename (Code Sec. 197(d)(1)).

Goodwill and going-concern value. Goodwill is the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name or reputation of the trade or business or to any other factor (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Generally, going-concern value is defined as the additional value that attaches to property because it is an integral part of a going concern. It includes the value attributable to the ability of a trade or business to continue to operate and generate income without interruption in spite of a change in ownership (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Goodwill and going-concern value acquired prior to August 10, 1993, are not amortizable.

Workforce in place. Workforce in place includes the composition of a workforce (for example, its experience, education or training), as well as the terms and conditions of employment and any other value placed on employ-

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● ● *CCH Explanation*

ees or any of their attributes. Thus, the portion of the purchase price of an acquired business attributable to the existence of a highly skilled workforce is amortizable over 15 years. Similarly, the cost of acquiring existing employment contracts or relationships with employees or consultants (including any "key employee") as part of the acquisition of a trade or business is amortizable over 15 years (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Information base. This category includes business books and records, operating systems; customer lists; subscription lists; insurance expirations; patient or client files; and lists of newspaper, magazine, radio or television advertisers. For example, the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems may be amortized as a section 197 intangible (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Know-how. A patent, copyright, formula, process, design, pattern, know-how, format, or similar item is a section 197 intangible. Such property generally includes package designs, computer software, and interests in films, sound recordings, video tapes, books, or other similar property. Special rules, described below at .04, apply to such property (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Customer-based intangibles. A customer-based intangible refers to the composition of a market, a market share, and any other value resulting from the future provision of goods or services resulting from relationships (contractual or otherwise) with customers in the ordinary course of business (Code Sec. 197(d)(2)). The term "customer-based intangible" is specifically defined to include the deposit base and any similar asset of a financial institution (Code Sec. 197(d)(2)(B)). According to the House Committee Report, "similar assets" include items such as checking accounts, savings accounts, and escrow accounts.

Typical examples of customer-based intangibles include the portion of an acquired trade or business attributable to the existence of a customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts, investment management contracts, or other relationships with customers that involve the future provision of goods or services (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Supplier-based intangibles. This term is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer (Code Sec. 197(d)(3)). For example, the portion of the purchase price of an acquired business attributable to the existence of a favorable relationship with persons that provide distribution services such as favorable shelf or display space at a retail outlet, the existence of a favorable credit rating, or the existence of favorable supply contracts are section 197 intangibles (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Governmental licenses, permits, etc. The amortization deduction applies to the cost of acquiring a license, permit, or other right granted by a governmental unit, agency, or instrumentality (Code Sec. 197(d)(1)(D)). The issuance or renewal of a license, permit, and other right granted by the government is treated as an acquisition. The fact that the term of a license or

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permit is indefinite or renewable for an indefinite period does not affect its status as a section 197 intangible (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66)

Examples of amortizable governmental licenses, permits, and rights include liquor licenses, taxicab medallions, airport landing or takeoff rights, regulated airline routes, and television or radio broadcasting licenses. However, a government-granted right in an interest in land or an interest under a lease of tangible property is not a section 197 intangible (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Covenants not to compete. A covenant not to compete which is entered into in connection with the direct or indirect acquisition of an interest in a trade or business or a substantial portion of a trade or business is amortizable as a section 197 intangible. Amounts paid or incurred for such a covenant are chargeable to capital accounts and ratably amortized over 15 years. Amounts paid under a covenant not to compete after the tax year in which the covenant is entered into are amortized ratably over the remaining amortization period applicable to the covenant (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66)

A taxpayer may acquire an interest in the trade or business of a corporation or a partnership through the direct purchase of its assets or by purchasing stock or partnership interests

An arrangement similar to a covenant not to compete is also a section 197 intangible. For example, excessive compensation or rental paid to a former owner of a business for continuing to perform services or for the use of property is considered an amount paid for a covenant not to compete if the services or property benefits the trade or business (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

An amount paid under a covenant not to compete which actually represents additional consideration for the acquisition of stock in a corporation is not a section 197 intangible and must be added to the basis of the acquired stock (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Franchises, trademarks, and tradenames. A franchise, trademark, or tradename is a section 197 intangible. A franchise is defined as an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities within a specified area (Code Sec. 197(d)(1)(F), (f)(4)(A); Code Sec. 1253(b)(1)).

Under Code Sec. 1253(d)(1), a taxpayer may currently deduct certain amounts paid or incurred on account of a transfer of such property that are contingent on the productivity, use, or disposition of a franchise, trademark, or tradename. All other amounts, whether fixed or contingent, that are paid on account of the transfer of a trademark, tradename, or franchise are chargeable to capital account and are ratably amortized over a 15-year period. The renewal of a franchise, trademark, or tradename is treated as an acquisition of the franchise, trademark, or tradename (Code Sec. 197(f)(4)).

.03 Exclusion of self-created intangibles.—Generally, a section 197 intangible created by the taxpayer is not amortizable unless it is created in connection with a transaction or series of related transactions that involves the acquisition of assets constituting a trade or business or a substantial portion of a trade or business (Code Sec. 197(c)(2)). According to the House

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Committee Report, a section 197 intangible, such as a technological process or other know-how, is considered created by a taxpayer if it is produced for the taxpayer by another person under the terms of a contract entered into with the taxpayer prior to the production of the intangible (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

The exclusion for self-created intangibles does not apply to:

(1) entering or renewing a contract for use of a section 197 intangible;

(2) any license, permit or other right that is granted by a governmental unit or agency;

(3) a covenant not to compete entered into in connection with the direct or indirect acquisition of all or a substantial portion of a trade or business; or

(4) any franchise, trademark, or tradename.

Thus, for example, the 15-year amortization period would apply to the capitalized costs of registering or developing a trademark or tradename (Code Sec. 197(c)(2), House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

.04 Other exclusions.—The following intangible assets are specifically excluded from the definition of a section 197 intangible:

(1) interests in a corporation, partnership, trust, or estate;

(2) interests under certain financial contracts;

(3) interests in land;

(4) certain computer software;

(5) certain separately acquired rights and interests;

(6) interests under existing leases of tangible property;

(7) interests under existing indebtedness;

(8) sports franchises;

(9) residential mortgage servicing contracts; and

(10) certain corporate transaction costs (Code Sec. 197(e)).

Interests in a corporation, partnership, trust or estate. Thus, the cost of acquiring stock, partnership interests, or interests in a trust or estate may not be amortized regardless of whether such interests are regularly traded on an established securities market (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66)

Interests under certain financial contracts. Interest under existing futures contracts, foreign currency contracts, notional principal contracts, or other similar financial contract are not section 197 intangibles (Code Sec. 197(e)(1)(B)). An interest rate swap is excluded, according to the House Committee Report.

An interest under a mortgage servicing contract, credit card servicing contract, or other contract to service indebtedness that was issued by another person, and any interest under an assumption reinsurance contract are not excluded from the definition of the term "section 197 intangible" by reason of

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the financial contracts exception (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Special rules apply to certain mortgage servicing rights (see below) and assumption reinsurance rights (see .052, below).

Interests in land. An interest in land is not a section 197 intangible. Interests in land include fee interests, life estates, remainders, easements, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Computer software. Computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified is not a section 197 intangible. Other computer software is considered a section 197 intangible only if acquired in a transaction or series of related transactions involving the acquisition of assets constituting a trade or business or a substantial portion of a trade or business (Code Sec. 197(e)(3)(A)).

Computer software is defined broadly to include any program designed to cause a computer to perform a desired function. However, a data base or similar item is not considered computer software unless it is in the public domain and is incidental to the operation of otherwise qualifying computer software (Code Sec. 197(e)(3)(B)). Additionally, the House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66, provides that computer software includes any incidental and ancillary rights with respect to computer software that are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software and are used only in connection with the computer software.

See ¶ 11,009.015 for depreciation rules relating to computer software.

Certain interests or rights acquired separately. The following interests and rights are excluded from treatment as section 197 intangibles if not acquired in a transaction (or series of related transactions) involving the acquisition of the assets constituting a trade or business or a substantial portion of a trade or business:

(1) an interest (e.g., as a licensee) in a film, sound recording, video tape, book, or similar property (including the right to broadcast or transmit a live event);

(2) a right to receive tangible property or services under a contract or a right to receive tangible property or services granted by a governmental unit, agency, or instrumentality.

(3) an interest in a patent or copyright; and

(4) to the extent provided in regulations, a right received under a contract (or granted by a governmental unit, agency, or instrumentality) if the right has a fixed duration of less than 15 years or is fixed in amount and would be recoverable under present law under a method similar to the unit-of-production method (Code Sec. 197(e)(4)).

Interests under existing leases of tangible property. Interests in existing leases for tangible personal property (either as lessor or lessee) are not treated as section 197 intangibles.

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Interests under existing indebtedness. Interests in an indebtedness that is in existence on the date the interest is acquired, except for deposit items and other similar items specified in Code Sec. 197(d)(2)(B), are not treated as section 197 intangibles. For example, the value of assuming an existing indebtedness with a below-market interest rate or the premium paid for acquiring a debt interest with an above-market interest rate is not amortizable under Code Sec. 197. Additionally, this exception includes mortgage servicing rights, to the extent that such rights are stripped coupons within the meaning of Code Sec. 1286 (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Sports franchises. A franchise to engage in professional football, basketball, baseball, or any other professional sport, as well as any item acquired in connection with such a franchise, is not a section 197 intangible. Consequently, the cost of acquiring a professional sports franchise and related assets should be allocated among the assets without regard to Code Sec. 197.

Mortgage servicing rights. The right to service indebtedness which is secured by residential property is not a section 197 intangible, unless it is acquired in a transaction or series of related transactions involving the acquisition of assets (other than mortgage servicing rights) of a trade or business or a substantial portion of a trade or business.

Certain corporate transaction costs. Fees paid for professional services and other transaction costs incurred in a corporate organization or reorganization in which gain or loss is not recognized are not amortizable as section 197 intangibles.

.05 Dispositions of section 197 intangibles.—A taxpayer who disposes of an amortizable section 197 intangible that was acquired in a transaction but retains other section 197 intangibles acquired in the same transaction (or a series of related transactions) may not claim a loss deduction as a result of the disposition. Instead, the bases of the retained section 197 intangibles are increased by the amount of the unrecognized loss (Code Sec. 197(f)(1)). According to the House Committee Report, abandonment of a section 197 intangible and events that render such property worthless are dispositions of such property.

The nonrecognition of loss rules do not apply to dispositions of separately acquired section 197 intangibles (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Upon a disposition, the adjusted basis of each retained section 197 intangible is increased by the product of (1) the amount of the loss that is not recognized, and (2) a fraction, the numerator of which is the adjusted basis of the intangible on the date of disposition and the denominator of which is the total adjusted bases of all the retained section 197 intangibles on the date of disposition (House Committee Report for Revenue Reconciliation Act of 1993, P.L. 103-66).

Covenants not to compete. A taxpayer may not treat a covenant not to compete as disposed of or worthless any earlier than the disposition or worthlessness of the entire interest in the trade or business (or substantial portion thereof) with respect to which the covenant not to compete was entered into.

Controlled groups. All members of the same group of controlled corporations are treated as a single taxpayer with respect of the disposition of a